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SUBJECT: BERLUSCONI'S RECORD UNDER TREMONTI'S LEADERSHIP

REF: A) ROME 2630

B) ROME 2280

C) ROME 2389

D) ROME 791

E) ROME 402

F) 03 ROME 3679

G) 03 ROME 2674

**¶1.** SUMMARY: PRIME MINISTER BERLUSCONI HAS ANNOUNCED HIS INTENTION TO STAY AT THE HELM OF ITALIAN ECONOMIC DECISION-MAKING, FOLLOWING THE FORCED RESIGNATION OF FINANCE MINISTER GIULIO TREMONTI (REF A). WHILE THERE IS PRESSURE FOR THE PM TO APPOINT A PERMANENT SUCCESSOR SOONER, BERLUSCONI HAS HINTED HE MAY RETAIN THE PORTFOLIO UNTIL THE END OF THE YEAR, IN ORDER TO SEE THROUGH THE CONTENTIOUS DEBATE OVER THE 2005 BUDGET. WHOEVER REMAINS AT THE HELM OF THE MINISTRY OF ECONOMY AND FINANCE WILL FACE A SERIES OF DAUNTING CHALLENGES: REVIVING A STAGNANT ECONOMY AND DECLINING ITALIAN COMPETITIVENESS, MANAGING THE LARGEST NATIONAL PUBLIC DEBT IN THE EURO ZONE, AND TACKLING A HUGELY BURDENSONE, BUT POLITICALLY RADIOACTIVE, PENSION SYSTEM.

**¶2.** FINANCE MINISTER TREMONTI WAS ADEPT - SOME SAY TOO CLEVER -- AT FINDING WAYS TO CONTAIN ITALY'S BUDGET DEFICIT UNDER DIFFICULT INTERNATIONAL CIRCUMSTANCES. HE TOOK SOME STEPS TO ENCOURAGE BUSINESS SECTOR INVESTMENT AND ENCOURAGE THE REPATRIATION OF PRIVATE CAPITAL. DURING HIS WATCH, THE BERLUSCONI GOVERNMENT ALSO ENACTED SOME NOTEWORTHY LABOR MARKET REFORMS AND INTRODUCED A MODEST PENSION REFORM BILL (STILL TO BE ENACTED). HOWEVER, ON THE MOST IMPORTANT ISSUES - SERIOUS REFORM OF THE PENSION SYSTEM AND TAX STRUCTURE - TREMONTI AND HIS ECONOMIC TEAM FAILED TO MAKE SIGNIFICANT PROGRESS. THIS CABLE REVIEWS THE BERLUSCONI GOVERNMENT'S ECONOMIC RECORD UNDER TREMONTI'S TENURE AND EXAMINES THE CHALLENGES THAT FACE THE GOVERNING COALITION BETWEEN NOW AND THE NEXT NATIONAL ELECTIONS, WHICH MUST BE HELD NOT LATER THAN 2006. END SUMMARY.

THE STATE OF THE ECONOMY - THEN AND NOW

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**¶3.** WHEN PRIME MINISTER BERLUSCONI TOOK OFFICE, HE INHERITED A CRUSHING PUBLIC DEBT OF 110.6 PERCENT OF GDP, A RIGID LABOR MARKET, TEN PERCENT UNEMPLOYMENT, A BLOATED PUBLQ4-QL|CH BETTER. ITALY'S PUBLIC DEBT, 106.2 OF GDP PERCENT IN 2003 AND 105 PERCENT EXPECTED IN 2004, IS STILL THE HIGHEST IN THE EURO ZONE. GDP GROWTH IS EXPECTED TO BE ONLY 1.2 PERCENT THIS YEAR. GROWTH RATES IN 2002 AND 2003 WERE A PALTRY 0.4 AND 0.3 PERCENT, RESPECTIVELY. ITALY'S DEFICIT/GDP RATIO IS CLIMBING, AND COULD BREACH THE THREE PERCENT CEILING OF THE EU STABILITY PACT IN 2004, UNLESS A SPENDING CUT PACKAGE IS PASSED. ON A POSITIVE NOTE, UNEMPLOYMENT HAS FALLEN TO ABOUT NINE PERCENT. HOWEVER, REGIONAL DISPARITIES ARE STILL NOTABLE; WHILE NORTHERN ITALIAN FIRMS ARE DESPERATE FOR SKILLED LABOR, THE SOUTH'S UNEMPLOYMENT RATE IS NEARLY EIGHTEEN PERCENT (ADMITTEDLY SOFTENED BY A THRIVING UNDERGROUND ECONOMY).

**¶5.** THE BERLUSCONI GOVERNMENT CLAIMS THAT MACRO-ECONOMIC PERFORMANCE REMAINS POOR BECAUSE OF THE SLOW RECOVERY OF WORLD MARKETS, AND THE HUGE PUBLIC DEBT BURDEN IT INHERITED. CRITICS, HOWEVER, CHARGE THAT THE GOVERNMENT HAS FAILED TO ENACT MEANINGFUL STRUCTURAL REFORMS THAT WOULD HAVE HELPED TO TURN AROUND THE ECONOMY, POINTING SPECIFICALLY AT LABOR MARKET, TAX REFORM AND PENSION REFORM.

LABOR MARKET FLEXIBILITY

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**¶6.** ITALY LONG HAD ONE OF THE MOST SCLEROTIC LEGAL LABOR MARKETS IN EUROPE, WITH SEVERE LEGAL OBSTACLES TO HIRING AND FIRING WORKERS. EARLY ON, THE BERLUSCONI GOVERNMENT LIBERALIZED FIXED-TERM CONTRACTS, AND ANNOUNCED ITS INTENTION TO ABOLISH ARTICLE 18 OF THE LABOR CODE, WHICH ALLOWED THE REINSTATEMENT, USUALLY UNDER COURT ORDER, OF WORKERS DEEMED TO HAVE BEEN UNFAIRLY DISMISSED FROM COMPANIES WITH SIXTEEN OR MORE EMPLOYEES. THE PROSPECT OF ABOLISHING ARTICLE 18 SPARKED A PROTRACTED BATTLE WITH UNION FEDERATIONS, AND LED TO GENERAL STRIKES AGAINST THE GOVERNMENT. THE FIGHT WAS OVER MORE THAN JUST ARTICLE 18; AT STAKE APPEARED TO BE THE SOCIAL COMPACT - "CONCERTAZIONE"

NCERTAZIONE DESCRIBES THE 1993 TRIPARTITE AGREEMENT AMONG UNIONS, EMPLOYERS AND THE GOI, WHEREBY UNIONS ACCEPTED WAGE MODERATION AFTER NEARLY TWO YEARS OF FIGHTING, THE GOVERNMENT SETTLED FOR A COMPROMISE SOLUTION THAT ALL THREE PARTIES (WITH THE EXCEPTION OF ITALY'S LARGEST TRADE UNION FEDERATION CGIL) ACCEPTED: ARTICLE 18 WOULD BE SUSPENDED FOR THREE YEARS, BUT THE THREE-YEAR PERIOD WOULD ONLY START WHEN A PENSION REFORM BILL WAS PASSED. (MORE ON PENSIONS BELOW.) ALTHOUGH APPROVING THE AGREEMENT, PARLIAMENT WILL HOLD A HEARING ON HOW THIS AGREEMENT WOULD AFFECT IT WITHIN AND OUTSIDE OF THE COALITION ARGUED THAT THE BERLUSCONI GOVERNMENT WASTED TIME AND POLITICAL CAPITAL OVER ARTICLE 18, WHEN MORE PRESSING LABOR MARKET REFORM WAS REQUIRED. WHILE PROBABLY ACCURATE, THIS CRITICISM FAILS TO ACKNOWLEDGE THAT THE CENTER-RIGHT GOVERNMENT HAS ENACTED OTHER MEASURES THAT HAVE MADE THE LABOR MARKET MORE FLEXIBLE.

¶ 19. THE MOST NOTABLE OF THESE WAS THE SO-CALLED BIAGI LAW, WHICH ENCOURAGES MORE PART-TIME EMPLOYMENT BY REDUCING EMPLOYER SOCIAL SECURITY CONTRIBUTIONS FOR THESE WORKERS. THE BIAGI LAW ALSO CREATED OPPORTUNITIES FOR OUTSOURCING, JOB-SHARING AND THE USE OF PRIVATE EMPLOYMENT SERVICES. U.S. COMPANIES HERE REPEATEDLY TELL US THEY ARE QUITE SATISFIED WITH THE FLEXIBILITIES THEY HAVE FOR HIRING EMPLOYEES. HOWEVER, THE "EXIT" OR FIRING OF WORKERS REMAINS AN IMPORTANT OBSTACLE FOR EMPLOYERS.

¶ 110. OVERALL, THEREFORE, THE GOVERNMENT RATES A B-MINUS IN TERMS OF LABOR MARKET REFORM: SOME PROGRESS, BUT MUCH STILL NEEDS TO BE DONE.

#### PENSION REFORM

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¶ 111. ITALY'S PENSION SYSTEM IS EXTRAORDINARILY GENEROUS: MANY ITALIANS QUALIFY FOR A FULL STATE PENSION AT AGE 57. AS A RESULT, THE GOVERNMENT IS HEMORRHAGING MONEY TO FUND PENSIONS, SPENDING ABOUT FOURTEEN PERCENT OF GDP (ALMOST 30 PERCENT OF THE ITALIAN BUDGET). WITHOUT MEANINGFUL REFORM, THE PERCENTAGE IS EXPECTED TO CLIMB TO SIXTEEN PERCENT IN 2020, AND PERHAPS AS HIGH AS 20 PERCENT IN 2030.

¶ 112. THE BERLUSCONI ADMINISTRATION IS TREADING LIGHTLY ON PENSION REFORM, FOR FEAR OF ALIENATING VOTERS AND TO KEEP THE COALITION INTACT. (THE 1994 BERLUSCONI GOVERNMENT FELL PRIMARILY OVER BATTLES WITHIN THE COALITION OVER PENSION REFORM.) IN 2003, THE GOVERNMENT INTRODUCED LEGISLATION TO RAISE THE RETIREMENT AGE FOR STATE PENSIONS TO 60 YEARS OF AGE BEGINNING IN 2008, AND TO PROVIDE INCENTIVES FOR THOSE WORKING PAST RETIREMENT AGE. ACCORDING TO GOVERNMENT ESTIMATES, SPENDING ON PENSIONS WOULD INITIALLY INCREASE BECAUSE OF THESE INCENTIVES; BUT BEGINNING IN 2008, OVERALL EXPENDITURES WOULD FALL BY 0.5 TO 1 PERCENT. LABOR MINISTER MARONI HAS ARGUED, HOWEVER, THAT SAVINGS WOULD BE GREATER, AS GOVERNMENT ESTIMATES ABOVE DO NOT FACTOR IN SAVINGS FROM INCENTIVES TO EMPLOYEES TO REMAIN IN THE WORKFORCE.

¶ 113. THE GOVERNMENT'S INITIAL PROPOSAL WOULD HAVE BROADENED THE CATEGORY OF WORKERS WHO MUST WORK UNTIL 60. HOWEVER, BECAUSE OF OPPOSITION WITHIN THE COALITION, THE PROPOSAL WAS WATERED DOWN, AND ONLY A SMALL CATEGORY OF WORKERS NOW WOULD HAVE TO WORK UNTIL 60.

¶ 114. PROSPECTS FOR TIMELY PASSAGE ARE UNCLEAR. THE SENATE AND THE CHAMBER OF DEPUTIES HAVE PASSED THE PLAN, BUT THE DIFFERENCES IN BILLS MUST BE RECONCILED. MARONI ASSERTED THAT THE CENTER-RIGHT CHAMBER LEADERS WORKED WITH SENATE COUNTERPARTS AS THE CHANGES WERE NEGOTIATED TO ENSURE THAT EXPEDITIOUS PASSAGE. LIKEWISE, THE PRIME MINISTER AND FORMER FINANCE MINISTER TREMONTI EXPRESSED OPTIMISM THAT PARLIAMENT WILL PASS THE REVISED MEASURE THIS SUMMER.

¶ 115. THE GOVERNMENT'S PENSION REFORM PROPOSAL IS NOT FAR-

ESS, ITS PASSAGE WOULD BE A MODEST AND HELPFUL STEP IN THE RIGHT DIRECTION. GIVEN THE DIFFICULTY OF ENACTING PENSION REFORM FOR ANY GOVERNMENT, THE BERLUSCONI ADMINISTRATION WILL DESERVE A C-PLUS ON PENSION REFORM - IF THE GOVERNMENT SUCCEEDS IN PASSING ITS PLAN THIS SUMMER.

#### FINANCIAL MARKET REGULATORY REFORM

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¶ 116. IN THE WAKE OF PARMAFATI'S 18 BILLION DOLLAR FRAUD, WHICH FOLLOWED ON THE HEELS OF MISMANAGEMENT AND MALFEASANCE BY ITALIAN FOOD COMPANY CIRIO, THE GOVERNMENT IN JANUARY DRAFTED MEASURES TO STRENGTHEN THE OVERSIGHT POWERS AND PUNITIVE AUTHORITY OF CONSOB, ITALY'S SEC-EQUIVALENT, AND TO REVOKE THE CENTRAL BANK GOVERNOR'S LIFETIME MANDATE. (THE CENTRAL BANK HAS BEEN HIGHLY CRITICIZED FOR NOT BEING MORE

VIGILANT IN ITS MARKET SUPERVISION.) MANY CONSIDER GREATER MARKET OVERSIGHT ESSENTIAL TO CALM CONCERN OF JITTERY INVESTORS, BOTH DOMESTIC AND FOREIGN. THE LEGISLATION WAS DRAFTED BY THE FINANCE MINISTRY IN RECORD TIME, BUT HAS SINCE LANGUIISHED. WITHIN THE COALITION, POLITICAL LEADERS ARE ARGUING OVER WHETHER CONSOB AND THE ANTI-TRUST AUTHORITY, WHOSE AUTHORITY WOULD ALSO INCREASE, SHOULD HAVE SUCH POWERS, AND WHETHER CENTRAL BANK GOVERNOR FAZIO SHOULD HAVE HIS LIFETIME MANDATE REVOKED AND REPLACED BY AN EIGHT YEARS MANDATE. PRIVATE SECTOR ENTITIES, INCLUDING THE ITALIAN BANKERS' ASSOCIATION, HAVE CONCERN ABOUT THE POTENTIAL FOR INTERFERENCE IN THE MARKETS BY THE INTER-MINISTERIAL COMMITTEE ON SAVINGS, WHICH ALSO WOULD BE GIVEN NEW OVERSIGHT AUTHORITY UNDER THE DRAFT MEASURE.

¶17. GIVEN ITS INABILITY TO REACH CONSENSUS AND ADOPT MEASURES CRITICAL TO RESTORING TRUST IN THE MARKETS, THE GOVERNMENT SO FAR DESERVES A FAILING GRADE IN FINANCIAL MARKET REGULATORY REFORM.

#### TAX REFORM

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¶18. AS SOON AS EUROPEAN PARLIAMENTARY ELECTIONS WERE OVER, THE BERLUSCONI GOVERNMENT RENEWED CALLS FOR FAR-REACHING TAX MEASURES (AN UNFILLED BERLUSCONI CAMPAIGN PROMISE DATING FROM THE 2001 ELECTION), INCLUDING BOTH LOWERING OF TAX RATES AND A REDUCTION IN THE NUMBER OF TAX BRACKETS. THE CUTS COULD AMOUNT TO AS MUCH AS TWELVE BILLION EURO.

¶19. LONG SIMMERING DIFFERENCES OVER FISCAL POLICY AMONG COALITION PARTNERS QUICKLY CAME TO THE SURFACE, HOWEVER, AND WERE A MAJOR FACTOR IN THE CONFRONTATION THAT LED TO TREMONTI'S OUSTER. SIMPLY PUT, FORZA ITALIA AND THE NORTHERN LEAGUE SUPPORTED SOME BREAKS FOR LOW-INCOME EARNERS, BUT LARGE REDUCTIONS FOR TAXPAYERS WITH INCOMES BETWEEN 80,000 AND 1,000,000 EUROS. THE ALLEANZA NAZIONALE AND THE UDC, IN CONTRAST, OPPOSED A TAX BREAK FOR "THE RICH," BOTH FOR THE POLITICAL MESSAGE IT WOULD SEND AND FOR THE CONSTRAINTS REDUCED REVENUES WOULD PLACE ON THE GOVERNMENT'S ABILITY TO FUND AN-FAVORED PROJECTS, ESPECIALLY IN SOUTHERN ITALY.

¶20. THE DETAILS OF BOTH FURTHER FY 2004 SPENDING CUTS TO KEEP ITALY BELOW THE EU'S THREE PERCENT DEFICIT/GDP RATIO, AS WELL AS TAX AND SPENDING PLANS FOR THE FY 2005 BUDGET, ARE STILL TO EMERGE. HOWEVER, BASED ON ITS PERFORMANCE SINCE 2001, IT IS HARD TO CREDIT THE GOVERNMENT WITH MORE THAN STAVING OFF FISCAL DISASTER IN A DIFFICULT INTERNATIONAL ENVIRONMENT. POLITICALLY CHALLENGING BUT ECONOMICALLY ESSENTIAL STRUCTURAL REFORMS HAVE BEEN AVOIDED. THE TAX AND SPENDING PRIORITIEQQQI>QLD ACTION IN THE MONTHS AHEAD. WE THEREFORE FIND IT HARD TO GIVE THE GOVERNMENT MORE THAN A C-MINUS ON FISCAL POLICY.

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